Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Morrow	Analyst:	Roger Lackey	Bill Number:	SB 2104
Related Bills:	None	Telephone:	845-3627	Introduced Date:	02-25-2000
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Agricultural Disasters/Accelerated Depreciation & NOL Deduction For Farmers Affected By Natural Event

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (BCTL), this bill would provide an election to expense the cost of certain qualified property and a net operating loss (NOL) deduction for a farmer who experiences a "natural event."

Under the Government Code, this bill would add "natural events" to the emergencies applicable to the standardized emergency management system operated by the Office of Emergency Services (OES).

This analysis will discuss the changes to the Government Code only as they impact the department's programs and operations.

EFFECTIVE DATE

This bill would become effective upon enactment as an urgency statute and would be operative for taxable and income years beginning on or after January 1, 2000.

BACKGROUND

The Government Code defines three types of emergencies: a "state of war emergency," a "state of emergency," and a "local emergency." Among other things, both a state of emergency and a local emergency may include a number of disasters that may directly impact farmers, including flood, storm, epidemic, drought, plant or animal infestation or disease. A war emergency can exist without a proclamation by the Governor, if the federal government receives a warning. However, both the state of emergency and a local emergency must be duly proclaimed by the Governor.

SPECIFIC FINDINGS

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business. However, expenses for purchasing property with a useful life in excess of a year must be capitalized and depreciated over several years rather than deducted in the year purchased.

Federal law provides that an NOL can be carried back two years and forward 20 years. An NOL is defined as the excess of allowable deductions over gross income computed under the law in effect for the loss year.

Board Position:			Department Director	Date
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Existing state law generally conforms to the federal computation of the NOL; however, California does not allow NOL carrybacks. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward will vary.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1	100%	8 Years
Year 2	100%	7 Years
Year 3	100%	6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100%	5 Years
	50%	10 Years
TTA, LAMBRA & EZ	100%	15 Years

For most taxpayers, 50% of the computed NOL may be carried forward for five years. Special NOL treatment, as stated in the above chart, is provided for the following taxpayers:

- New Businesses that are in a trade or business activity that first commenced in California after January 1, 1994. "New Business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable or income years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.

- Eligible Small Businesses that are in a trade or business with gross receipts, less returns and allowances, of less than $1 million during the taxable or income year.

- Taxpayers that suffer a casualty loss in an area declared a disaster area by the Legislature may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

- Taxpayers that operate a business in a Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area (TTA) or Enterprise Zone (EZ). However, NOLs generated in these incentive areas may only offset income generated in the incentive areas, and only one such NOL may be claimed in any year.

Special rules apply for taxpayers who have different types of NOLs generated in the same year. Generally, taxpayers operating in various tax incentive zones or within and outside tax incentive zones must allocate their overall loss between their various zone and non-zone activities. The deduction for such a taxpayer is limited to just the NOL from one particular zone loss to the exclusion of all other losses or to a carryforward of the entire loss under the general NOL rules.

This bill would allow a "qualified taxpayer" to elect to deduct as a business expense a specified amount of the cost of qualified property purchased and placed in service in replacement of property lost or damaged as a direct result of a natural event, as defined in the Government Code.

The deduction would be allowed in the taxable or income year in which the taxpayer places the qualified property in service. The election would be made on the original return. The basis of the property would be reduced by the amount of the deduction. The maximum deduction for all qualified property would be the lesser of (a) 40% of the cost; or (b) the following:

If the property was placed in service:

Taxable or income year of loss or damage	$100,000
1st taxable or income year thereafter	$100,000
2nd taxable or income year thereafter	$75,000
3rd taxable or income year thereafter	$75,000
Each taxable or income year thereafter	$50,000

This bill would provide that a “qualified taxpayer” may elect to carryover 100% of the NOL attributable to the business activities within the area affected by the natural event. The NOL could be deducted against future years' income attributable only to business activities within the area affected by the natural event. The amount of the natural event NOL would be determined by computing the business loss then applying a percentage (apportioning) to calculate the natural event portion of the loss. The natural event NOL would be a carryover to each of the 15 taxable or income years following the loss.

This bill would define a “qualified taxpayer” as a farmer.

This bill would add “natural events” to the emergencies and disasters that the OES would include in the application of its standardized emergency management system. “Natural events” would include, but not be limited to, pest infestation, plant diseases, or freezes that actually damaged or threaten to damage agricultural property.

Policy Considerations

Under the Government Code, the term “natural events” would include threatening to damage agricultural property. It appears that a farmer whose property is not actually damaged by a “natural event,” but only threatened by a "natural event," would be eligible for the business property expensing deduction and the NOL deduction provided for by this bill. The author may consider narrowing the term “natural event” to include only events and damage that actually occur.

This bill would establish a deduction for which federal law has no counterpart, as a result, the deduction would create a state and federal difference.

Implementation Considerations

Although this bill would include “natural events” in the standardized emergency management system developed by the OES, it is unclear if this bill would actually provide the Governor or the OES the authority to declare a “natural event,” or if the OES is required to make a declaration for the taxpayer to receive the benefits of this bill. It also is unclear how a natural event would differ from a “state of emergency” or a “local emergency,” which also may include infestations and plant diseases.

Further clarification is needed to ensure that taxpayers properly understand when and where a "natural event" has occurred.

This bill would provide the same benefits allowed to qualifying taxpayers in EZs, LAMBRAs, and the TTA. However, this bill would not specify how boundaries would be established for the "natural event." As a result, it may be difficult to determine if the election to expense the cost of certain qualified property and the NOL deduction are actually attributable to a "natural event" or the threat of a natural event.

Once the implementation considerations are resolved, this bill would require the development of new tax forms and instructions and information systems, which could be accomplished during the normal annual update.

Technical Considerations

Under both the PITL and B&CTL NOL provisions added by this bill, there is an incorrect reference regarding the loss carryover and limitations set forth. Amendments 1 and 2 are provided to correct these references.

FISCAL IMPACT

Departmental Costs

Once the implementation concerns are resolved, this bill is not expected to significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of SB 2104 Income/Taxable Years Beginning On or After 1/1/2000 Enactment Assumed After June 30, 2000 **(In Millions)**			
	2000-1	2001-2	2002-3
Revenue Impact*	$0.5	$2.5	$3.5

* The impact from the expensing allowance is projected to be minor, on the order of $500,000 annually, and is included.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

For the NOL portion of the bill, it was assumed that a natural event would result in crop-related and other losses equaling $300 million per year (approximately 20% of total acreage per year). Using an NOL micro-simulation model, the effect of this loss on operating losses and NOL carryover deductions was calculated assuming 50% and 100% carryover rates.

The tax impact (on the order of $3 million for the first year) was estimated on the basis of the difference between these two NOL figures.

The expensing allowance is projected to be rather minor because of the 40% allowance limited by the expensing maximums and the fact that some farms will have operating losses for the year.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S PROPOSED AMENDMENTS TO SB 2104
As Introduced February 25, 2000

AMENDMENT 1

On page 15, line 22, strikeout "subparagraph (B)" and insert:

paragraph (2)

AMENDMENT 2

On page 27, line 31, strikeout "subparagraph (B)" and insert:

paragraph (2)